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August 24, 1993

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Via Federal Express

Federal Communications Commission
Office of the Secretary
1919 M Street, Room 222
Washington, DC 20554

93-215

RE: **Tele-Media Corporation Comments in Response to Notice of Proposed Rulemaking - Cost of Service**

Gentlemen and Ladies:

Enclosed please find an original and six copies of comments filed on behalf of Tele-Media Corporation in response to the Notice of Proposed Rulemaking - Cost of Service.

Should there be any questions, please do not hesitate to call.

Sincerely yours,

Jonathan P. Young

Jonathan P. Young
Corporate Attorney

Enc.

cc: Jon A. Allegretti
Allen C. Jacobson, Esq.
Steve E. Koval

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AUG 25 1993

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BEFORE THE

FEDERAL COMMUNICATIONS COMMISSION

Washington, DC 20554

In the matter of:	)	
	)	
Implementation of Sections of	)	
the Cable Television Consumer	)	MM Docket No. 93-215
Protection and Competition Act	)	
of 1992	)	
	)	
Rate Regulation	)	

COMMENTS

TELE-MEDIA CORPORATION

Date: August 25, 1993

INDEX

OUTLINE OF COMMENTS

I. BACKGROUND

A. Nature of Operator

The Tele-Media organization ("Tele-Media") was founded in October 1970 by two cable pioneers who still actively participate in the overall operation and management of the companys' cable systems. Tele-Media is a multiple system operator ("MSO") with approximately 450,000 equivalent basic subscribers. The organization operates approximately 170 separate cable systems. Of this number, 87 systems (or over half) have less than 1,000 subscribers. Another 50 systems have between 1,000 and 3,499 subscribers. Historically, Tele-Media has either acquired or originally built lower density rural systems and is typical of many medium size operators in the cable industry.

B. Nature of Historical Financing

As a medium size operator with many small systems, Tele-Media has access to only certain capital financial markets. It is not a public company. Thus, the availability of capital must come from commercial banks (like the 18 banks who wrote expressing concern to the Federal Communications Commission ("FCC") on June 21, 1993, with over 17.1 billion in financial commitments to the industry, a copy is attached as Exhibit I), private institutional lenders, and venture capital funds. Unlike larger organizations that operate higher and larger density systems, there is a lack of alternative sources of revenue, such as pay per view, to draw upon.

Currently the commercial lenders have adopted a wait and see attitude in making further financial commitments to most segments of the cable operating community. The banks and private institutional lenders analyze the cash flow which a system can reasonably be predicted to yield to determine if they will make capital available to an operator. They are waiting to determine the effect of rate regulation through benchmarks or cost-of-service showings on cash flow before proceeding in their decision making processes. As a result of this uncertainty commercial lenders have not been lending to the industry. This has put a grinding halt to system expansions, rebuilds, upgrades and further planning for the telecommunications superhighway. Therefore, it is important that any regulated system yield enough to pay the debt and provide a reasonable return on investment.

C. Effect of Inability to Obtain Financing

Perhaps the most significant negative impact of a cable operator's inability to access capital financial markets will be seen and felt by the consumer. When no new money is available to operators, consider what happens to: 1) expansions, rebuilds and upgrades; 2) mergers and acquisitions; and 3) vendors and affiliated business industries. The first consequence that will occur will be the retardation of growth and an operational standstill of the cable industry. With no financing available for capital expenditures, the operator will not be able to expand, rebuild, or upgrade the system. Who is hurt? The consumer, because in systems that are not "state-of-the-art", such as many within the Tele-Media family, the telecommunications infrastructure to provide a superhighway will not be possible.

Other consequences that occur when mergers and acquisitions fail to take place are that the operators are unable: 1) to institute operating efficiencies enjoyed by large MSOs (which would save the consumer money); and 2) to provide more programming. Again it is the consumer who suffers. Finally, lack of funds affects vendors providing programming, materials, supplies and all affiliated business industries. When cable systems don't expand, rebuild or upgrade the demand for components and materials drops dramatically. Without demand, the manufacturer of those items is faced with no choice but to cut back production. This leads to a reduction in the work force.

The FCC need only look at the credit crunch starting in late 1990 when lenders were severely restrained by bank regulators from making highly leverage loans (the type made to Tele-Media and many cable operators) to see evidence of this effect. In State College, Pennsylvania manufacturers of cable related equipment and supplies, such as C-COR Electronics, Inc., experienced significant layoffs in the early 1990's as a direct result. The consequences of retardation of growth and technology in the cable industry, failure to reduce cost to the consumer and loss of jobs while not intended will occur unless the cost-of-service rules allow for a fair and reasonable profit to cable operators, as intended.

II. **REGULATORY GOALS**

A. Cost-of-service

1. Flexibility

From the view point of an MSO operating lower density rural systems, it is imperative that the cost-of-service regulatory rules be flexible enough to be applied to every cable company reflecting a number of different factors which are applicable to that operator. The true cost for operating high, medium and low density systems vary greatly. The dynamics of geography and demography will also affect the true costs of operating cable systems. The FCC must ask, "What is the true cost of getting the signal to the subscribers in each system?" The answer is different in each system because of the density, geography and demographics. These are three areas of evaluation that should be given greater weight by the FCC. The regulatory framework must "compare apples to apples" if the goal is to produce rates that approximate competitive rate levels.

2. Transition Period

The cost-of-service standards need to also reflect the cable industry as it exists today. It has reached its current posture after three decades of evolution. In order to meet the main Congressional objective of lowering cable rates for subscribers under the Cable Television Consumer and Protection Act of 1992 ("1992 Cable Act"), the cable industry will have to be remolded. This objective will take time. It was not Congress' intent nor is it in the public interest to restrict the growth of the industry, or to reduce the variety and quality of programming, or to injure many people beyond repair. Implementing the cost-of-service rules as proposed, will result in these unintended consequences. The proposed cost-of-service rules seek to change overnight an industry's course of conduct which has evolved over 30 years. Unlike other regulated industries where the traditional cost-of-service formula is applied, the cable industry does not have standard financial reporting practices or operating procedures. In addition, the traditional formula assumes that all cable systems are similar in nature. This is not how the cable industry has evolved over the years. As a result, there is a need for a reasonable transition period to permit a mature industry to meet the goals of the 1992 Cable Act.

It is patently unfair to require cable operators to make an election of reducing rates to the benchmarks or selecting a cost-of-service showing without publishing the rules for the cost-of-service showing in advance. This is what is happening. It would be in the best interest of both cable operators and consumers to complete the rule making process in advance of any initial responses to franchise authorities or the FCC. The FCC can ameliorate the harshness of such actions by providing in the final rules a transitional period that will allow operators to make adjustments that will better serve the public. An example of a transitional act is set out in paragraph 29 of the Notice of Proposed Rulemaking, where it is suggested that depreciation practices be monitored for a time instead of instituting a specific depreciation method simply because it provides an instant means to an end with very detrimental unintended consequences.

B. <u>Cost-of-Service Rules Should Not Mirror the Benchmark</u>

If the intent of the cost-of-service rules is to provide a viable alternative to the benchmarks with the goal of allowing operators the opportunity to justify rates that exceed the benchmarks but are reasonable because they are based on cost, then the cost-of-service rules cannot mirror the benchmarks.

A stated goal for the cost-of-service requirements is to form a "backstop" to the benchmarks. This is to enable the cable operators to justify their rates based on cost. The benchmarks specifically determine the maximum permitted rate that can be charged. The cost-of-service rules are designed to allow the operator to justify a rate higher than the benchmarks so that the operator will be able to realize enough revenue to pay its bills and stay in business. If it can't stay in business charging the benchmark rates and the cost-of-service rules mirror the benchmarks to effectively reduce the rate to the benchmarks, then the operator will not have a backstop as suggested in the proposed rule making.

The FCC must ask, "What is the cost of delivering the signal to the subscriber?" Let us look at one example. If you build a mile of cable plant at a cost of $15,000 per mile, the number of homes passed and the number of subscribers you serve will be one factor in determining the cost of delivering the signal to the subscriber. See the following chart:

# of Homes Passed in One Mile of Plant	# of Subscribers (60% penetration rate)	Construction Cost of plant per homes passed
20	12	750
40	24	375
60	36	250
100	60	150

In this example, assuming the cost of construction of the cable plant is the same and the cost of generating the signal and operating the support facilities is the same, the revenue will vary based on the number of subscribers per mile of plant. However, the cost invested per homes passed is significantly higher where the density is lower. The specifics of each system will vary based on many factors including demographics, labor costs, geographic conditions, seasonality and density as in the above example.

It is easy to state the obvious by asking the following questions. Is it in the public interest to restrict the growth of the industry? Is it in the public interest to restrict programming made available to the public? Is it in the public interest to have legislative restrictions so narrow or the application of rules that they do not permit a cable operator to maintain financial integrity, to attract capital and to allow recovery of all reasonably incurred costs, plus a reasonable rate of return on its investment? The answer to each question is also an obviously resounding NO! The FCC has specifically stated that it is not their intent in implementing cost-of-service rules to allow these consequences to occur. The FCC must be steadfast in its resolve, because without some thought to the consequences of a viable alternative to justify rates, the consumer and the cable operator will both suffer needlessly.

III. Regulatory Requirements

A. Procedural Requirements

If the cost-of-service rules do not justify the existing rate, then the regulatory body has the right to lower it, even to an amount below the benchmark. Balancing that right should be a concomitant ability to permit an increase, in the initial regulatory rates, if the cost-of-service rules justifies such an increase and, but for the rate freeze or some special circumstance, the rate would have been higher.

B. Cost-of-Service Standards

To implement the cost-of-service showings, the FCC has suggested the use of a standard form to be completed by cable operators. In designing this form and the related instructions, the FCC must provide for flexibility since there could be different types of cost-of-service showings. For instance, one type of showing may relate to the addition of channels and another type of showing may relate to the establishment of the initial regulated rates. Similarly, a large MSO may have different factors that effect their costs compared to a medium sized MSO such as Tele-Media.

The FCC intends to use the traditional formula of cost-of-service to regulate the cable industry. While this approach is acceptable, there are many details involved in defining the components of the traditional formula that must be tailored to the specifics of the cable industry as it exists today with its current capital structure. Throughout the following sections, we will comment on the various components involved in the traditional formula.

1. Annual Expenses

a. Operating Expenses

To provide incentives to cable operators to continue to expand their program offerings, the FCC should permit a markup on programming expenses in its development of cost-based rates. One of the primary benefits to consumers since deregulation of the cable industry in 1986 was to significantly increase the amount of programming. The FCC needs to ensure that in a regulated environment the incentives exist to motivate cable operators to continue to offer additional services to consumers.

b. Depreciation

Due to the various differences in cable systems, such as the age, technological development, and other similar factors, setting one standard of depreciation, for the entire cable industry, is impractical. Instead, the FCC should only monitor the practices followed by the cable companies considering the various factors mentioned above.

c. Taxes

Due to the need to attract private equity sources and to avoid double taxation, Tele-Media is primarily comprised of partnerships and subchapter S corporations. Our organization is typical of many companies within the industry. To exclude the tax liability attributable to the income of subchapter S corporations and partnerships would exclude significant costs of providing regulated cable services to consumers. We should not be penalized due to our legal form of business which was established for various legitimate reasons. Therefore, it is only fair that taxes should be considered for all types of entities and not just C corporations.

2. Rate Base

a. Valuation of Plant in Service

The FCC appears to be leaning toward valuing plant in service at original cost. Tele-Media strongly disagrees with this method. First of all, the original cost will not be available in most instances since Tele-Media and the cable industry went through a period of significant merger and acquisition activity during the 1980's. As a result of this activity, we have no records of the original cost of the plant in service. Instead, when purchasing assets, cable operators assign an allocated portion of the purchase price to plants in service.

Secondly, many of the plants that Tele-Media owns are technologically outdated since they were originally built years ago by predecessor companies in the rural, low density areas that we operate, when compared to some of the newer and larger cable systems. As a result, the plants may be almost fully depreciated and using the original cost approach will cause the rate base to be minimal. Finally, the original cost method would result in the lowest rate base providing little capital dollars, if any, to be able to develop the telecommunications superhighway being touted by the Clinton administration.

Considering these facts, Tele-Media considers the replacement cost method the best alternative for the industry. A replacement cost approach would allow Tele-Media to upgrade our plants to keep up with technological developments in the industry while at the same time taking advantage of cost efficiencies that result from this development to keep the cable rates to consumers at a reasonable level. To ensure the continuity of replacement costs within the industry, the FCC could monitor the reasonableness of the cost assigned by operators given certain technological factors of each cable system.

b. Excess Acquisition Costs

Given the merger and acquisition activity by Tele-Media and the entire cable industry over the past decade, in an era of growth, the exclusion of excess acquisition costs would be devastating to our operations. Over the years, cable operators, such as Tele-Media, purchased cable systems based on their market value expecting to earn a return on their investment considering the risk involved. A portion of the market price was allocated to intangibles based on industry practices. Since the entire purchase price was financed by either debt or equity, Tele-Media must receive a return on the entire purchase price, which includes intangibles, to be able to service its debt and provide reasonable equity returns commensurate with the level of risk that are expected by our investors. In addition, the related amortization expenses must be included as an annual expense under the traditional formula to provide a fair and reasonable profit to cable operators.

Amounts assigned to intangibles, such as subscriber lists, franchise rights and pole attachment agreements, have true values that benefit cable operators with similar characteristics as the cable plant. For instance, franchise rights and pole attachment agreements allow cable operators the legal right to operate in a specific geographic area for a definite period of time and also allow operators the right to attach to a utility company's poles. Therefore, the underlying values of intangibles are just as important to cable operators as the plant. To ignore these values from the rate base would be totally unreasonable. Since the FCC is taking an unregulated industry into a regulated environment, at a minimum, there needs to be a transitionary method of handling intangibles. Such a method might be to recognize intangibles incurred prior to re-regulation in the rate base and to include their related amortization as an expense over the life of the franchise.

The bottom line is that if the FCC disallows the value of intangibles to be included in the rate base and also excludes amortization expense, then most cable operators, including Tele-Media, will lack the sufficient revenue to cover their obligations to our lenders (ie: principal and interest), local franchise authorities (ie: line extension requirements) and the FCC (ie: technical and customer service requirements). As a result, we will be forced out of business since we will not be able to recognize a fair and reasonable profit as required in the 1992 Cable Act.

If the FCC does agree to include amortization of intangible costs as part of annual expenses, then the amortization period should be the life of the franchise at a maximum since it offers a definite period of time over which the benefits are realized by the cable operator.

c. Plant Under Construction

There should be no limits on inclusion of plant under construction in the rate base. Cable operators should be allowed a return on this investment since they need to service any debt incurred to expand, upgrade or rebuild the plant. By including plant under construction in the rate base, the FCC will provide incentives to cable operators to develop the information superhighway which will benefit consumers through access to additional programming and other video services.

d. Recovery of Accumulated Losses

One of the basic premises of cable rate regulation is that cable operators should be given the opportunity to recover their expenses and earn a fair and reasonable return on their investment. As various studies have shown, the cable industry as a whole has operated with significant net losses. These losses need to be recouped since they have been financed with debt and equity similar to the cable plant. Therefore, we recommend that accumulated losses be considered as part of the cost-of-service rules. This is an important element that cannot be ignored.

e. Working Capital

With the credit crunch experienced by cable operators, many companies, including Tele-Media, may have operated with negative working capital which would reduce the rate base. Therefore, we recommend the development of an industry-wide working capital allowance to be used by all operators.

3. Rate of Return

To suggest that each cable company has the same rate of return is totally unrealistic. As illustrated by the affidavit attached as exhibit II, Tele-Media's cost of capital is significantly higher than that of a large MSO, such as TCI. Specifically, many of our bank loan agreements provide for a higher interest rate due to the smaller size of the transactions completed by Tele-Media vs. the larger cable operators. Furthermore, banks look for repayment in eight years while the public market lenders (ie: bonds) utilized by phone companies and larger cable operators allow repayments of 10, 15, and in some cases 20 to 30 years. Tele-Media has also financed a large portion of its cable company acquisitions with subordinate debt and equity capital from venture capital funds. With respect to subordinate debt, Tele-Media pays an interest rate typically in the high teens to mid-twenties. In contrast, larger MSO's have paid as little as 9% for subordinate debt (ie: Continental Cablevision).

With respect to equity capital, public institutional investors which invest in large MSO's demand a return on investment in the teens. In contrast, private venture capital funds have historically looked for Tele-Media to provide a return on investment in excess of 30%, sometimes even exceeding 40%. Recently, some of these firms have suggested that they would consider lowering their equity return expectations to between 25% and 30%. It is important to note that these rates are at lease double the rate of return being proposed by the FCC. In addition, these amounts still exceed the amounts paid by larger cable companies and telephone companies. The aggregate effect of the foregoing is that smaller operators, including mid-size MSO's such as Tele-Media, are required to pay out a significantly greater portion of their monthly revenue for higher cost capital than telephone companies or larger MSO's. Therefore, the best approach would be to permit each cable company to submit its own rate of return based on its current capital structure.

The FCC proposes the use of a surrogate with similar levels of risk to determine the rate of return for the cable industry. In addition, the FCC has suggested that the S & P 400 may be an appropriate surrogate. Generally, the S & P 400 is comprised of large companies with access to the public markets. As pointed out above, the size and access to capital markets varies greatly within the cable industry. As the size and access to capital markets varies widely within the cable industry, the assessment of risk and rate of return fluctuates accordingly. There is no documentation of the level of risks in cable as compared with the risks associated with the larger public firms comprising the S & P 400 or any subgroup thereof. If such a study were completed, our opinion is that there would be a significant differential between the level of risk in cable and the S & P 400. Therefore, as stated previously, each cable system should be able to document their own rate of return based on their particular capital structure.

When computing the rate of return for a cable company, projected results should primarily be utilized. Similarly, projected results should be used for expenses when presenting a cost-of-service showing. If a cable operator is determining its future rates based on a cost-of-service showing then the rates need to be sufficient to cover projected costs and provide a reasonable profit.

C. Cost Accounting and Cost Allocation Requirements

To adopt a uniform system of accounts for cost-of-service showings would create costly administrative burdens on Tele-Media and other cable operators. We would need to revamp our accounting software packages utilized for management and external reporting purposes which, in turn, would increase our operating costs and the resulting rates charged to subscribers. This would produce no benefit to the consumer and could not be considered to be in the best interest of the public.

In regards to cost allocations, our overall opinion is that cost-of-service showings should be prepared at the company level as opposed to the system or franchise level since that is the current level that most operators, including Tele-Media, maintain their accounting records. However, if allocations are necessary, then cable operators should have the flexibility to make them in the most rational basis instead of the FCC adopting a single method to allocate costs.

D. Streamlining Alternatives

1. General Alternatives

An abbreviated cost-of-service showing for significant prospective capital expenditures would be beneficial. However, the comments seem to indicate that such costs would be added only to increase the benchmark. The rules should also permit for a shorter time frame for re-evaluation of the cost-of-service showings when considering significant capital expenditures.

2. Small Systems

Cable systems with fewer than 1,000 subscribers, regardless of ownership (individual or by an MSO) should be relieved of the burdensome requirements under a cost-of-service showing. A simple income statement approach would alleviate the administrative burden.

IV. **COLLECTION OF INFORMATION**

Tele-Media agrees with the conclusion of the FCC in relying on an annual survey of a sampling of cable systems. This should be done within certain categories of systems with each category established by certain defined system characteristics, including density, channel capacity, miles of plant and number of subscribers.

V. **CONCLUSION**

The cable industry is comprised of a wide variety of companies, including large, publicly held multiple system operators with millions of subscribers; individual owners of one, two or three small systems ("mom and pops"); and privately held, medium sized companies, like Tele-Media. These companies operate cable systems of different sizes, designs, and capacities serving communities of all sizes, from high density urban areas to low density rural areas. As Tele-Media has demonstrated throughout these comments, the size and type of operator and the size and type of system significantly affect the costs associated with providing cable television service. These costs can vary so widely from the average, that the application of the benchmarks frequently provides an inappropriate and unworkable solution to the task of regulating cable rates. The goal of a cost-of-service showing is to account for deviations because they represent the realities of operating cable television systems today.

To account for these deviations, the FCC must develop flexible and realistic cost-of-service guidelines so that cable operators can justify the rates necessary to maintain the high quality and variety of services presently provided, to build out to those places where cable is not yet available, to continue upgrading systems to access new technologies and to maintain financial